**Written Testimony of**
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**United States Senate Committee On Commerce, Science and Transportation**

**On "Wall Street Perspective Of**
**1996 Telecommunications Act Implementation"**

Mr. Chairman, thank you for the honor of testifying before your Subcommittee on behalf of the Precursor Group[SM] of Legg Mason Wood Walker, Inc. on the very important topic of the financial markets perspective of implementation of the 1996 Telecommunications Act.

I request that my full written testimony be printed in its entirety in the hearing record.

Before I comment on the Telecom Act implementation, it is important to provide a little background on the Legg Mason Precursor Group in order to understand my unconventional perspective. I am not a traditional Wall Street sell-side analyst who analyzes companies or recommends the purchase of stocks. I am a policy analyst for the investment community who tracks regulatory, technological, and competitive developments in the communications sector for large institutional investors including many of the largest mutual funds, pension funds, banks, and insurance companies in the United States.

My institutional investor clients read my newsletter and consult with me because, unlike most of Wall Street, I do not focus my efforts on what will happen in the next quarter, but focus on trying to anticipate *broadly* what will happen in the next 3-18 months. The Precursor Group[SM] attempts to anticipate investment-relevant change that others do not see, fully appreciate, or yet understand. To the extent possible, my clients expect my best unbiased and unvarnished assessment of "what is and what will be," rather than the common "what should be" analysis of company advocates and those involved in the political or regulatory process.

With that in mind, I have devoted most of my time and that of my staff over the last few years trying to understand where the 1996 Telecom Act is taking us.

I offer the following insights and observations on the implementation of the Telecom Act in hopes that these will be useful to the Subcommittee.

## I. Effect on Financial Markets

In general, financial markets dislike competition and uncertainty. "Large Cap" investors, which control the overwhelming majority of money managed in the United States, don't like the prospect of increasing competition because it creates uncertainty about future profit margins. For these investors in the most widely-held companies, the "competition" rhetoric from Washington generally frightened them and caused them to spend an enormous amount of time "war-gaming" out various competitive scenarios. On the other hand, investors in small companies and startups cheered passage and implementation of the Telecom Act because of the new opportunities it afforded.

However, the enormous confusion and uncertainty that has emerged from the legal fight over the implementation of the Telecom Act has served no one well. After years of uncertainty over the new rules of competition and subsidies, I am beginning to detect that the markets are increasingly "numb" to regulatory and legal developments. There is a growing mood of "wake me up when something really happens in the marketplace."

## II. Problems With Telecom Act Assumptions

It is increasingly apparent that many of the problems with the implementation of the Telecom Act are actually serious problems with some of the core assumptions underpinning passage of the Telecom Act.

***A. Overly Optimistic Technology Assumptions:*** The Telecom Act apparently assumed that technology had advanced to the point that there could be an *economically viable* and *widespread* facilities-based alternative to the local voice infrastructure in the reasonable future. As it turns out, the cable industry grossly over-promised on the viability of its infrastructure as a direct replacement to the copper voice architecture. Also greatly over-hyped was the *reliability* of wireless technology *at a replacement price*; that prospect is still a few years off at least and then probably will only begin as a niche service.

Much of the bitter legal and regulatory struggle that has transpired over the last two years may be rooted partly in this incorrect core assumption. Regulators are dutifully and desperately trying **to cram the Telecom Act's "two-pipe policy" into what remains a predominantly "one-pipe world"** for the foreseeable future.

***B. Natural Monopoly?*** The Telecom Act's optimistic technological assumptions have fueled conventional wisdom that the local loop voice architecture is no longer a "natural monopoly." However, it appears that local telephone service may still be a natural monopoly, meaning that the enormous capital cost of replicating local infrastructure suggests that consumers can get a better rate from one regulated provider who enjoys the full benefits of economies of scale. In addition, the 1934 policy of universal phone service and the 1980s subsidies of local service through inflated long distance access charges have resulted in roughly 94% of Americans enjoying near-perfect local residential dialtone service substantially below real cost.

However, unless we see a dramatic technological breakthrough which lowers the price of alternative local architectures, I believe that for at least 80-90% of American consumers, local phone service will remain a "natural monopoly" for another five years -- maybe longer.

*But What About Existing Local Competition?* The local competition that exists now, or is developing, almost exclusively benefits big business and not residential consumers. There remains very little prospect for widespread residential competition in the foreseeable future. Current local competition is fueled by subsidy-price arbitrage. If local monopolies were allowed to offer their business customers service at a "competitive" rate, i.e., closer to their cost, most existing local competition would vanish overnight. Policy makers should understand that current local business competition is fueled predominantly by three factors:

- *First, there is huge subsidy-price arbitrage.* The business rate "umbrella" for local service is still substantially inflated in relation to cost because regulators have chosen to cross-subsidize residential service with high business rates. Thus current competitors enjoy regulatory-imposed inflated prices without paying the offsetting regulatory-imposed extra costs of subsidies. What is really going on is less about competition (as most businesses know it) and more about politically

reallocating residential subsidies to CLEC shareholders. What we have now is competition for governmental subsidies.

• *Second, there is simple "cream-skimming."* New competitors can target their capital investment with laser-like efficiency on only the low-cost, high-volume customers. In other words, in the current policy vacuum of no new explicit universal service system, local competitors can serve only the best customers without having to pay for the less profitable customers it leaves behind. We are currently in a "free-lunch" transition period for competitors, where they get only the best of the old subsidy system and don't have to factor in all of the hidden future liabilities in the new explicit system. In addition, the current practice of CLECs aligning with Internet service providers (ISPs) to take advantage of voice reciprocal compensation two-way arrangement for data traffic, which largely flows only one way, is the policy equivalent of a "broken ATM machine" giving away money to whomever plugs into it. This transitional "loophole" benefit to current nascent competitors is not, in my opinion, sustainable long term.

• *Third, money is extraordinarily cheap right now*. The current booming economy with low inflation makes it relatively easy for most business proposals to find capital.

***C. Competition and Universal Service Compatible?*** The Telecom Act assumes that competition and universal service are compatible goals. While they are definitely both laudable and outstanding policy goals, *in practice* they are not complementary goals. In fact, they are probably much more directly contradictory than most will publicly admit. The FCC euphemistically refers to these goals as being in "dynamic tension" with one another. Unless regulators perfectly balance everything and the courts stay out of the way, either universal service will end up undermining competition, or competition will end up undermining universal service. Profit maximizers simply do not want to serve unprofitable customers unless they have to. Currently, prices are set politically -- not by market forces. If competition ultimately eliminates subsidies, then American residential consumers' rates are going up – probably by a lot.

***D. Can Competition Develop In Advance Of Subsidy Reform?*** The Telecom Act directed the FCC to begin promoting competition before reforming subsidies. This implementation sequence is backward. Like a breech birth, there is great risk that local competition could be stillborn because of the backward implementation sequence. How can a "competitive market" be created and thrive when prices bear little relation to cost and the outlook for reforming the pricing structure is so completely uncertain?

***E. Telecom Policy Moved From the Courts to the FCC and States?*** Congress assumed that by removing Judge Greene and the Modified Final Judgment of the AT&T Consent Decree from the telecom policy making process that the states and the FCC would determine final telecom policy. It hasn't turned out that way. One court has been replaced by multiple courts.

With "20-20 hindsight," it shouldn't be surprising that, in an artificial market where the government sets prices and has created competition for off-budget subsidies, every party would go to court to keep or get "theirs." Virtually every substantive policy dispute is being litigated: federal-state jurisdiction, constitutionality, pricing authority, unbundled element interpretations,

subsidy reform issues, etc. The Telecom Act has unleashed a lot of conflict without spelling out exactly how to resolve it. The current litigating trend will probably only get worse as subsidy reform heats up and as the Internet (which knows no jurisdictional boundaries) becomes more mainstream.

## III. Problems With Telecom Act Implementation

***A. The Politics of "Telecom Tic-Tac-Toe":*** As is commonly understood, the game of "tic-tac-toe" is so simple, that two sophisticated players will always play to a draw. That's because it is so easy to block your opponent from winning. Implementation of the Telecom Act is a lot like a game of "Telecom tic-tac-toe." No one is going to "win" and the game will continue to be played to draws because it is so easy to block the other side from gaining a permanent winning advantage. Apparently the markets have become intuitively accustomed to this game, realizing that the result of this repetitive blocking game is "the triumph of the status quo."

***B. Local Competition and Bell Entry Into Long Distance:*** While Congress, regulators, and the markets thought there would be more local competition and Bell entry into long distance than there is now, it hasn't worked out that way for many of the reasons outlined above. The sector is essentially in a status quo "holding pattern" for about a year or more awaiting resolution from the Supreme Court on the validity of the FCC's local competition rules, and the constitutionality of the Bell-specific provisions of the Telecom Act.

It is becoming increasingly apparent that in the next couple of years we will not see much widespread local *competition beyond the business market in the big cities*. Unless there is a technological breakthrough lowering the cost of alternative service, or most state regulators rebalance rates by substantially raising residential local rates, local competition in 90% of the residential market will be stillborn.

As for Bell entry into long distance, it is very unlikely that we will see the FCC approve a Bell entry application for long distance in 1998 and probably not in 1999, because it is increasingly apparent that the FCC and the Justice Department have a very tough standard of what an "open local market" means. While the Clinton Administration supported the Telecom Act, it is no secret that the Administration was less than enthusiastic about the prospect of loosening the standard for allowing Bell entry into long distance. So it should not come as a big surprise that while the law changed the procedure for reviewing Bell entry, the Administration did not change its implicit standard for Bell entry. It appears that the Administration believes that "open for competition" still means the old Judge Greene "8c" standard, that *"…there is no substantial possibility that it could use its monopoly power to impede competition in the market it intends to enter."*

Moreover, it is pretty clear that the FCC does not view Bell entry in the public interest because they are implementing the checklist under the tacit assumption that the Bells will abuse their market power unless regulators can prevent any and every potential way the Bell could leverage their monopoly position. The only way I see broad-scale Bell entry into long distance in this century is if the Telecom Act is ultimately ruled unconstitutional by the court, which, by the way,

is much more of a wildcard possibility than conventional wisdom suggests.

***C. The "Catch-22" of Widescale Broadband Investment:*** Apparently the primary way regulators know to encourage local competition is to restrain the incumbent monopolies from exercising their market power. This approach assumes that if only the incumbent monopoly can be prevented from blocking competition, then competition will flourish. (Never mind the fact that most consumers currently get their local service far below cost – arguably a long-standing anti-competitive political decision.)

However, the ripple effect of this policy approach to local competition is to tacitly discourage local loop investment upgrades by the incumbent as anti-competitive. The regulatory logic apparently is that a new competitor compete cannot compete if a monopoly is unfettered to offer improved broadband service? The unintended but practical result of this approach is that the government has created two classes of investment: investment by competitors that is welcome and good; and investment by monopolies that is bad, anti-competitive and essentially an unfair cross-subsidy that needs to be stomped out.

The *"Catch-22"* of this policy approach is that fairness to competitors takes precedence over fairness to consumers. Therefore, consumers must wait for competitors to offer them broadband services -- which is unlikely to occur in most consumer markets because current local service is offered below cost for political reasons. This is partly why two years after the Telecom Act, consumers are still screaming "where's my promised new bandwidth?"

The *"Catch-22"* is the fact that the current local policy holds the vast majority of the nation's hundred-million subsidized consumers hostage to competition that won't be showing up in their neighborhoods anytime soon. Like a cruel joke, at least eighty million American households are being left "on hold" waiting for a "competitive" rescue, which no competitor plans to launch in the foreseeable future.

Moreover, the current regulatory approach of insisting on unbundled resale at rates that guarantee competitors a profit, powerfully discourages investment by everyone involved. Why should competitors put capital at risk if they can lease at a guaranteed profit? (With the breakup of AT&T, the government guaranteed competitors *non-discriminatory access* to AT&T's network, *not access with a guaranteed profit for competitors*.) Why should incumbents invest in upgrading the local loop if a competitor can resell it for less than the amount necessary to recover the original cost of the investment? This perverse disincentive works like a "reverse patent," where only the competitor profits from innovative investment upgrades, not the original investor.

***D. Two Classes of Telecom Citizens?*** Value judgments aside, the Bell entry language in the Telecom Act and the FCC's implementation of it also has de facto created two separate classes of American citizens, a regulatory distinction that no average American citizen would understand if explained.

- One class of citizens includes those roughly 20 million American households that have an

incumbent phone company which can offer local, long distance and full Internet services. These roughly 50 million Americans either enjoyed that benefit before the Telecom Act passed (like Sprint customers) or were granted that benefit by Congress when the Telecom Act allowed GTE immediate entry into long distance in February 1996.

- A second class of citizens includes about 80 million households, or over 200 million Americans, who by quirk of geography or chance, were part of the old AT&T system and are now served by a Baby Bell. These consumers do not enjoy the benefit of an incumbent provider who can provide local, long distance and full Internet services. The Telecom Act created a now well-known separate process where a Bell must apply to the FCC after meeting a separate "competitive checklist" on a state by state basis before being able to offer long distance and full Internet service to their customers. These 200 million American citizens, only because of where they live, have to wait for the Bells and the FCC to break their regulatory stalemate before they enjoy the same regulatory treatment as the other roughly 50 million Americans. The practical result is different regulatory treatment. These 200 million American consumers will have one less communications alternative than their non-Bell brethren, and could enjoy substantially less broadband investment than their non-Bell brethren.

***E. Why The Subsidy Pie Will Grow:*** In contrast to conventional wisdom, it appears that telecom subsidies will grow rather than decrease over time as most expect. And unfortunately it looks as if consumers will end up paying for the increased subsidies unless a major change in the current dynamic occurs. The politically unintended end result where the consumer gets stuck with an increasing subsidy bill is likely for several reasons:

- *First,* it is much easier politically to add subsidies than it is to cut them. (Exhibit I: last May, after the FCC was lobbied furiously for months to flash cut local access charges by $10 billion, the FCC cut them ZERO in their access charge order out of fear than local rates would rise. On that same day last May, the FCC created $2.65 billion in new subsidies to fund Internet discounts for schools, libraries and rural health care. While the FCC thought the price cap reductions they also ordered that same day would pay for the new subsidies, it hasn't worked out that way. There is currently a lot of finger-pointing going on between the FCC, long distance carriers and the local telcos about whether consumers are actually getting the full benefits of the May reductions in the price caps.)

*Second*, many in and outside industry have sized up the estimated $20 billion plus in implicit telecom cross-subsidies as an off-budget "piggy bank" to be raided because it is largely unaccounted for and not well-understood by anybody. Consequently, there are a growing number of ideas to spend and re-spend this "new-found" money.

- *Third*, unlike the budget deficit, there is no official or widely accepted method of accounting for these telecom subsidies, and there is unlikely to be any good accounting anytime soon. That's because while the Telecom Act gives the FCC primary jurisdiction over *future* universal service funding, the *existing* system of subsidies is mostly controlled by the 50 states. And that's also because precious few individuals outside the big telecom companies truly understand the full intricacies of the arbitrage or business value of the various arcane subsidies.
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- *In sum*, I fear telecom subsidies will grow because it is the path of least political resistance; because targeted, powerful corporate interests overwhelm the diffuse and outgunned consumer interests; and because no one is running a tab on the overall cost. It's just a bunch of receipts sitting in different bureaucratic drawers somewhere.

***F. 1980s "Win-Win" Situation Makes Future "Lose-Lose":*** The breakup of AT&T spurred decreasing long distance prices. Regulators were able to add inflated long distance access charges to the decreasing long distance rates to keep local rates low. No consumer noticed because, due to the per-minute nature of long distance rates, long distance bills fluctuate. This was a political "win-win" situation. Now the Telecom Act has unleashed forces which threaten to turn that "win-win" into a "lose-lose" political situation. As competition siphons off or erodes subsidies, governments must either increase subsidies more or let local rates rise – which, because of their flat-rate nature, consumers will notice and will not like.

- Thank you for the opportunity to testify. I am available for questions.